

Market Bulletin

July 19, 2019

2Q19 Earnings bulletin: Threading the needle

In brief

- Manufacturing activity has softened on the back of unresolved trade tensions; Federal Reserve easing now seems likely into the end of the year.
- The current earnings season has been mixed; lower energy prices and a stronger dollar are headwinds, but health care sector M&A is providing an offset.
- Buybacks are supporting 2Q earnings; share repurchases look set to continue, but will only offset so much weakness in margins and revenues.
- 2020 consensus earnings estimates are too high at 11% and will need to decline; as this occurs, focus on cyclical value.



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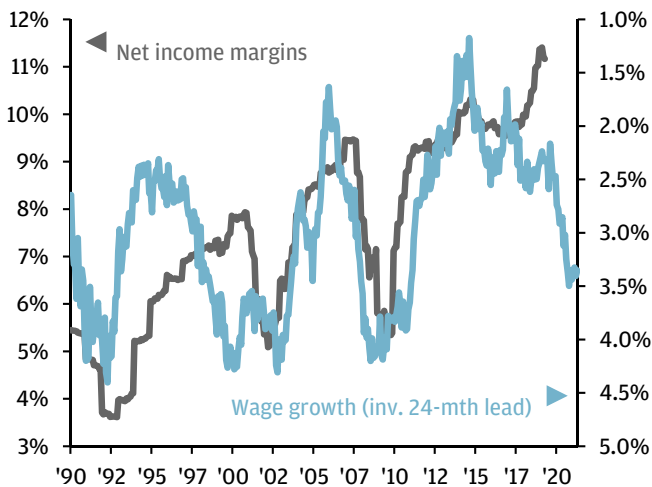
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TRADE, PROFITS AND THE CONSUMER

Trade tensions have been the main driver of weakness in the manufacturing sector this year. While this weakness has been offset at a global level by the relative resilience of the services sector, a disappointing May jobs report and slide in inflation expectations that began in September 2018 has led many, including the Federal Reserve (Fed), to worry that the end of the expansion might be closer than originally thought. As a result, we have seen a dovish pivot by the U.S. central bank, with an interest rate cut now likely at the end of this month. Although such action will fail to boost growth or inflation, it may provide a lift to inflation expectations, which seems to be the Fed's underlying goal.

The risk remains, however, that softer nominal economic growth will continue to drag on corporate profits. While many companies have already taken steps to offset this weakness by slashing CAPEX and investment spending, at the current juncture, there isn't much else on the investment side that can be cut. The wage growth seen over the past 24 months should begin to impact profit margins, suggesting further weakness in earnings will be met with labor force reduction. In an economy like the U.S. that is 70% consumption, labor market weakness will have a significant impact on growth, making the outlook for profits key to successfully gauging the longevity of this cycle.

EXHIBIT 1: Profit margins should come under pressure due to rising wage costs
 Net income margins, %, y/y % change in average hourly earnings for production and nonsupervisory employees



Source: BLS, FactSet, Standard & Poor's, J.P. Morgan Asset Management. Wage growth has a 24-month lead. Net income margins are based on last 12 months earnings per share divided by sales per share. Data are as of 7/19/2019.

Against this backdrop, the 2Q19 earnings season is underway; with 22.5% of S&P 500 market capitalization having reported, we estimate that operating earnings rose 2% from a year prior. Thus far, 78% of companies have beaten earnings estimates, but only 42% of companies have beaten sales estimates. Furthermore, decomposing the current quarter's growth estimate

highlights that the majority of earnings growth is set to come from buybacks, as margins appear relatively unchanged and revenue growth is soft.

While we see room for revenues to surprise to the upside, any sustained acceleration in sales will be a function of what happens with trade and the pace of economic growth. 2Q19 earnings growth should be positive on a year-over-year basis when all is said and done, but the third quarter looks set to be challenging. That said, favorable base effects in 4Q will provide a lift to profit growth, even if 3Q sees a contraction. As such, a 2019 profit recession should be avoided, but the margin for error is shrinking.

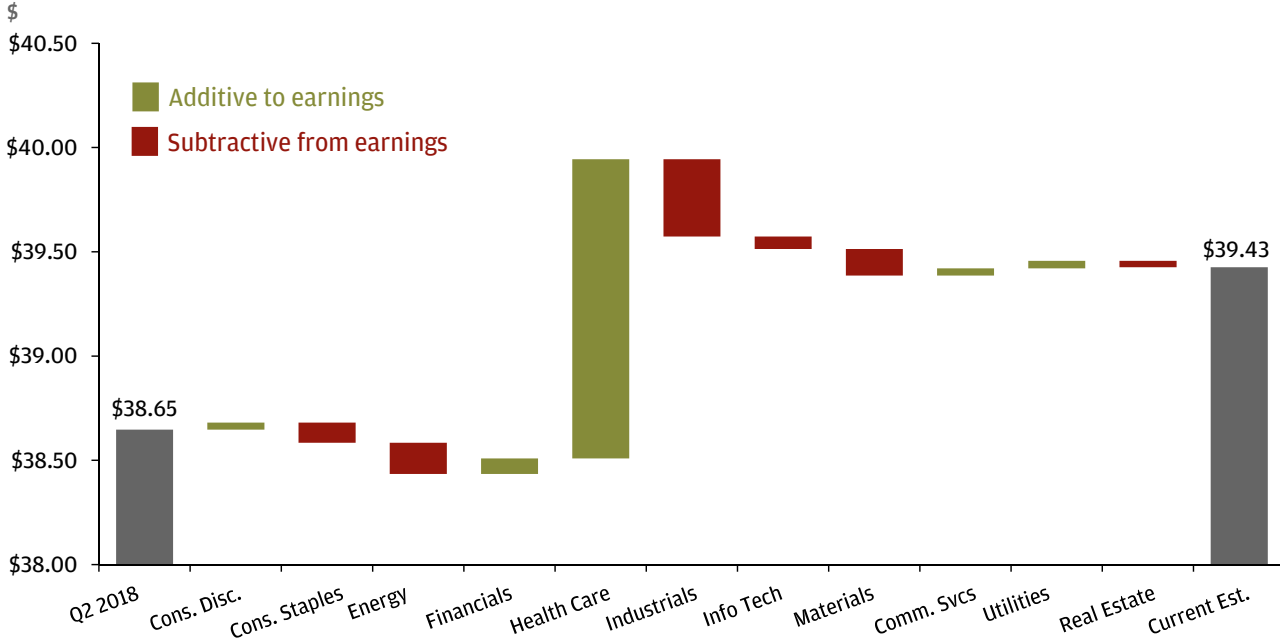
A little bit softer now

There are clouds hanging over the 2Q earnings season, as six out of eleven sectors are expected to see profits decline on a year-over-year basis. Furthermore, eight of eleven sectors are expected to see margins contract, a problematic development when revenue growth is softening. Although analysts are usually too pessimistic about the outlook for earnings once the reporting season begins, applying an average earnings surprise only pushes aggregate growth into the mid single digits.

The financial sector has kicked off the 2Q19 earnings season, and thus far, results have been mixed. Banks have beaten estimates in aggregate, but looking beneath the surface, trading and investment banking revenue has been soft, and the outlook for net interest margins has waned on the back of expected Fed easing. That said, consumer banking is solid, and with the majority of banks passing the Fed's Comprehensive Capital Analysis and Review (CCAR), buybacks look set to accelerate. This should provide a tailwind for financial sector earnings in the quarters to come.

The more globally exposed sectors face headwinds from slower global growth, uncertainty around trade

EXHIBIT 2: EPS contribution by sector



Source: Standard & Poor's, FactSet, Compustat, J.P. Morgan Asset Management. Data are as of 7/19/2019.

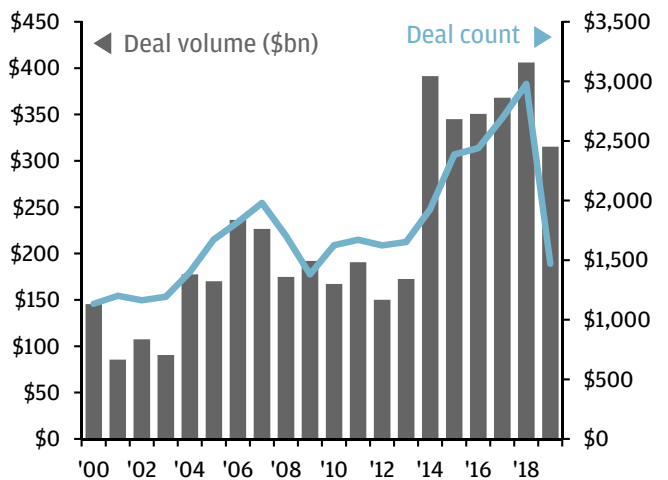
and a stronger U.S. dollar. Industrials and materials sit at the epicenter of the U.S./China trade conflict, and although some firms have taken steps to re-route supply chains in an effort to avoid tariffs, it is too soon for this to show up in the earnings figures. Furthermore, technology sector profits are under pressure, primarily due to trade tension-induced weakness at hardware and semiconductor companies. Inconveniently, this softening in technology earnings comes at a time when the sector's forward P/E ratio is sitting near its cycle high.

Energy companies likely struggled in the second quarter, as the average price of WTI oil was 11.7% lower than in 2Q18. Fracking continues to disrupt the energy sector, as breakeven prices for existing and new wells are still falling. However, the sector seems primed for an uptick in M&A activity during the coming quarters as the oil majors try to establish a stronger foothold in the fracking space. Furthermore, with investors increasingly focused on returns, rather than production volume, profitability is at the forefront of

many conversations. Finally, health care looks set to be the main driver of earnings this quarter, as M&A activity over the past few years provides a significant boost to inorganic growth via margin expansion.

EXHIBIT 3: Healthcare M&A has provided a boost to earnings this quarter

Global M&A deal volume, \$bn, deal count



Source: Bloomberg, J.P. Morgan Asset Management. Deals are based on announcement dates of completed and pending health care M&A deals. Deal volume does not include deals with undisclosed values. 2019 deals are year-to-date. Data are as of 7/19/2019.

Threading the needle

The risks to profit growth are rising, but it does not appear that we have reached the end of the road. We expect that earnings will grow around 4% for 2019 as a whole, but the path taken will be choppy. 3Q18 represented the high water mark for both earnings per share and profit margins, which, given our outlook for moderate growth and lackluster inflation, will make the 3Q19 earnings season particularly challenging. That said, 4Q18 earnings were negatively impacted by one-off accounting issues, so even if earnings growth turns negative next quarter there is immediate relief on the horizon.

The broader concern is what happens to earnings in 2020. The stock market has become exuberant as we seem to be making progress on trade, economic growth is slowing but not stalling, and the Fed has signaled its intention to ease policy into the end of this year. Unfortunately, however, all three of these things will not remain in place - either we will see a deal on trade and a less accommodative Fed, or a continued slowdown in economic and earnings growth and a Fed that is cutting aggressively in response to this weakness. As such, investors need to focus on the outlook for earnings, as weaker profit growth will be the first step toward a softer labor market and economic contraction. While a near-term recession is not our base case, it is an outcome that needs to be entertained.

At the current juncture, consensus is looking for 11% earnings growth next year, whereas our models are pointing to low single-digit growth. Absent an uptick in economic growth, 2020 estimates will need to come down in the next few months, likely causing the stock market to pull back and volatility to increase. Buybacks should still provide support to earnings, but will not be

able to keep profit growth positive if revenue growth continues to slow and margin contraction continues. With the S&P 500 trading at a forward P/E ratio of more than 17x, things seem priced for perfection; unfortunately, the outlook is far from perfect.

Investment implications

Given a backdrop of low, but positive, earnings growth, it still makes sense for investors to embrace cyclicality in portfolios in a measured way. We like technology, consumer discretionary and communication services from a structural standpoint, but recent performance and valuations deter us from suggesting a significant overweight. On the more defensive side of things, sectors such as utilities and consumer staples have rallied strongly as rates have fallen in recent weeks; if the Fed fails to deliver on 3 rate cuts, investors in these sectors should feel pain as interest rates move higher. As such, we prefer sectors, such as financials and energy, that offer yields greater than the broad index but will be far less impacted by rising rates.

The income component of total returns should help mute volatility at the portfolio level, leading to a smoother ride. That said, investors should be conscious of valuations, as low rates have led multiples to expand beyond sustainable levels given the fundamental outlook for profits and the broader economy.

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